7595 VENDOR ALLOWANCES – RETAILER PERSPECTIVE

Retailers whose business activity includes the resale of products obtained from manufacturers of products (vendors) sometimes receive allowances or incentives from the vendors. These vendor allowances can be various types of credits, rebates, or cash that the vendor pays the retailer who sells their product or service. The retailers may have arrangements with more than one vendor and may have more than one arrangement with the same vendor. The retailer and the vendor negotiate the terms and conditions of these vendor allowances. The issue is whether the vendor allowances are gross receipts for the retailer for California sales factor purposes for the retailer.

CCR §25134(a)(1)(A) provides the rules for when a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products has "sales" that are considered to be gross receipts. "Sales" in those situations includes all gross receipts from the sales of the goods or products to customers in the ordinary course of its trade or business.

CCR §25134(a)(1)(C) provides the rules for when a taxpayer engaged in providing services has sales that are considered to be gross receipts. "Sales" in those situations include the gross receipts from the performance of those services including fees, commissions, and similar items.

For taxable years beginning before 1/1/2011: "'Sales' means all gross receipts of the taxpayer not allocated under Sections 25123 to 25137, inclusive." (R&TC §25120(e), emphasis added.)

For taxable years beginning on or after 1/1/2011: "'Sales' means all gross receipts of the taxpayer not allocated under Sections 25123 to 25137, inclusive." (R&TC §25120(f)(1).) In addition, " 'Gross receipts' means the gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital . . . in a transaction that produces business income, in which the income, gain, or loss is recognized (or would be recognized if the transaction were in the United States) under the Internal Revenue Code, as applicable for purposes of this part. Amounts realized on the sale or exchange of property shall not be reduced by the cost of goods sold or the basis of property sold." (R&TC §25120(f)(2), emphasis added.)

For federal purposes there is

- Treasury Regulation §1.471-3(b) that provides the rules for trade discounts stating that trade discounts reduce the invoice price.
- Treasury Regulation §1.471-3(e) that provides the rules for sales-based vendor allowances stating that these decrease the cost of goods sold (COGS).

Options: There are three options for treatment of vendor allowances, with only one giving rise to a gross receipt for California sales factor purposes.

- Reduce COGS: The allowance paid by the vendor to the retailer reduces COGS for the retailer (i.e. purchase price) and does not give rise to a gross receipt when received.

  Example: If a retailer purchases item X from a vendor for $50, then sells it to a customer for $100, normally the retailer would have a gross receipt of $100 and income of $50. If a retailer receives an allowance for $10 per item sold and that $10 is treated as a reduction of COGS, the retailer will still have $100 in gross receipts for the one item sold, but income will be $60 instead of $50 when that item is sold. The question for sales factor purposes is whether the gross receipt is the $100 received from the customer, or if there is an additional gross receipt of $10 for the vendor allowance received. The retailer receives the $100 gross receipt when the item is sold to a customer. The fact that there is a certain amount of income (whether $50 or $60) does not change the fact that there is $100 in gross receipts. Even though there is additional income upon final sale to a customer due to the $10 allowance that reduces COGS, the gross receipt for sales factor purposes is still $100.

- Income: The retailer immediately recognizes income when the allowance is received. This only occurs when the retailer is selling a product or a service back to the vendor that is separate from the product or service that the vendor is selling to the retailer. These are gross receipts for California sales factor purposes.

  Example: If a retailer purchases item X from a vendor for $50, then sells it to a customer for $100, normally the retailer would have a gross receipt of $100 and income of $50. If the retailer receives an allowance of $10 per item sold and that $10 is treated as a separate item of income, then the amount of total gross receipts increases from $100 to $110 when item X is sold. The sourcing for the $10 (service) would likely be different than that for the $100 (sale of tangible personal property).

In addition, the total income would increase from $50 to $60 when the item X is sold to a customer due to the $10 allowance.

- Contra-Expense: The vendor allowance does not reduce the retailer's COGS and there is no immediate income recognition, but rather a positive expense entry offsetting the retailer's expense. There is no current income for the retailer and no deferred income from the vendor allowance.

  Example: If a retailer purchases item X from a vendor for $50, then sells it to a customer for $100, normally the retailer would have a gross receipt of $100 and income of $50. If the retailer receives an allowance of $10 per item sold and that $10 is treated as a contra-expense, then there is no change in the gross receipt of $100.

GENERAL GUIDELINES:

1. Vendor allowances are presumed to reduce COGS for the retailer and not to be gross receipts for California sales factor purposes. This presumption is overcome when the vendor allowance is either of the following:

   (a) Payment for Products or Services (revenue): If the payment from a vendor to a retailer is for products or services delivered to the vendor, the vendor allowance paid by the vendor is revenue and a gross receipt for the retailer provided the vendor receives an identifiable benefit (products or services) in exchange for the allowance paid to the retailer. The identifiable benefit must be both:

   1) Separable: The benefit to the vendor must be sufficiently separate from the retailer's purchase of the vendor's products or services so that the vendor would have entered into an exchange transaction with a party other than a retailer to provide the benefit.

   2) Measurable: The retailer must be able to reasonably estimate the fair value of the benefit provided to the vendor. If the vendor allowance paid by the vendor exceeds the estimated fair value of the benefit received by the vendor, that excess amount reduces COGS for the retailer and is not revenue or a gross receipt for that amount.

(b) Reimbursement of Costs (contra-expense): When a payment by a vendor to a retailer reimburses costs incurred by the retailer to sell the vendor's products, then the vendor allowance is a reduction of that cost for the retailer (contra-expense). If the vendor allowance paid by the vendor to the retailer exceeds the cost incurred by the retailer that is being reimbursed, that excess amount reduces COGS for the retailer. In either case, the vendor allowance is not revenue or a gross receipt to the retailer.

2. **Condition Precedent:** A rebate or a refund of a specified amount of vendor allowance payable under a binding arrangement that is only to be paid when the retailer completes a specified cumulative level of purchases or remains a customer for a specified period of time reduces, COGS. The reduction in COGS is allocated to each underlying transaction that results in progress toward earning the rebate or refund if the amounts are probable and can be reasonably estimated. If the rebate or refund is not probably and reasonably estimated, it should be recognized as the milestones are achieved. Factors that may impair a retailer's ability to determine whether a rebate or refund can be probably or reasonably estimated include:

   (a) The rebate or refund relates to purchases that will occur over a relatively long period.
   (b) There is no historical experience with similar products or lack of ability to apply experience due to changing circumstances.
   (c) In the past, significant adjustments to expected cash rebates or refunds were necessary.

   Examples:

   1. **Cooperative Advertising**: The vendor manufactures toys that are sold by a retailer. The vendor offers a cooperative advertising arrangement where the retailer receives an allowance for qualifying advertising costs of up to 2% of the total purchase from the vendor if certain qualitative criteria are met. The retailer must maintain documentation of advertising performed and related costs.

      Result:

The vendor allowance received by the retailer for cooperative advertising, to the extent that it represents a reimbursement of specific, incremental, and identifiable costs incurred by the retailer to sell the vendor's products, would be characterized as a reduction of those costs on the retailer's income statement (contra-expense), provided that the vendor allowance received does not exceed the costs incurred. If the amount of the vendor allowance exceeds the costs being reimbursed, that excess amount reduces the COGS for the retailer. If the retailer can show that the vendor received an identifiable benefit that was separable and measurable, then the vendor allowance may be revenue and a gross receipt for California sales factor purposes. If the result is neither contra-expense nor revenue, then the allowance reduces COGS and is not a gross receipt.

2. **Market Research Services:** The retailer enters into an agreement with a vendor to perform a significant amount of market research for the vendor related to the launch of a new product. The vendor believes that it is paying for the expertise and knowledge available to the retailer. The retailer believes the vendor is electing to purchase the retailer's knowledge of the market rather than internally develop such knowledge. The retailer would offer these services to a nonvendor.

   Result:

   The vendor allowance received is in return for services that provide an identifiable benefit to the vendor that is sufficiently separate from the retailer's purchase of the vendor's goods. Since the retailer offers those research services to nonvendors and the fair value of the research services is determinable, the vendor allowance received from the vendor represents revenue or gross receipts provided the vendor allowance received does not exceed the estimated fair value of the benefit received by the vendor. If the amount of vendor allowance paid by the vendor exceeds the estimated fair value of the related benefits received, that excess amount reduces COGS and that excess is not a gross receipt for the retailer.

3. **Cash Payment if Purchase Threshold Amount during Calendar Year**: On 1/1/2011, in a binding agreement, the vendor offers a cash refund of $1,000 to the retailer if during 2011 the retailer purchases 1,000 units. The retailer on average purchases 1,700 units each year.

   Result:

   Since the retailer is entitled to the refund from the vendor based on the purchase of 1,000 units of inventory, the retailer should accrue the refund offer over the purchase of 1,000 units as an incremental reduction to COGS, provided it is probably and reasonably estimated that the retailer will purchase 1,000 units during 2011. This vendor allowance is a trade discount and not a gross receipt. There has been no sale of a product or a service from the retailer back to the vendor under CCR §25134(a)(1)(A) or (C) that would give rise to gross receipts to be included in the retailer's California sales factor.

4. **Payroll Allowance:** A retailer enters into an agreement with a vendor. The vendor agrees to pay an allowance to the retailer to have sales staff dedicated to promoting the vendor's product in the cosmetic department. The allowance is intended to cover a portion of the cost of in-store representatives. Certain marketing considerations, such as counter space, product placement, staffing, and pay incentives must be met to qualify for the credit. The contract is a multi-year agreement. The allowance is calculated as a percentage of actual sales of the vendor's products.

   Result:

   The analysis of this type of an allowance should be divided into its components between payroll, shelf space, and marketing.

- Payroll:

  a. Contra-Expense: If the allowance reimburses the retailer for costs that are specific, incremental, and identifiable then it is a contra-expense. Any amount paid that exceeds the identified retailer costs would be a reduction of COGS for the retailer. In either case, these are not gross receipts.

b. Revenue/Gross Receipt: If the allowance for payroll gives rise to an identifiable benefit to the vendor that is separable from the products being sold and measurable, then the allowance received by the retailer is income/revenue for the retailer and a gross receipt for California sales factor purposes. Any amount paid by the vendor that exceeds the benefit to the vendor reduces COGS for the retailer.

c. Reduction of COGS: If the result is neither a. nor b. above, then the allowance for payroll reduces COGS and is not a gross receipt for the retailer.

- Shelf Space: The portion of the vendor allowances for shelf space is not income/revenue because the benefit received (shelf space for product) cannot be separated from the actual product purchased from the vendor. Accordingly, this would be either a contra-expense or would reduce COGS, but in either case, it is not a gross receipt for California sales factor purposes.

- Marketing: If there is marketing required that gives rise to a benefit to the vendor that is separable and measurable, this is income/revenue to the retailer and a gross receipt for California sales factor purposes. Generally, services (marketing) are provided in return for the payment by the vendor. Any excess benefit received by the vendor over the fair value of the services provided to the vendor is reduces COGS for the retailer and is not gross receipt for California sales factor purposes. If the services provided are not separable or measurable, then the allowance for marketing reduces COGS and is not a gross receipt for California sales factor purposes.

5. **Merchandise Display Allowance**: A retailer enters into an agreement with a vendor that requires the retailer to provide space and tangible items for display of vendor's products. The display space is designed to be unique and project a particular image of the vendor and the vendor's products. The design, layout, and

signage are based on the vendor's specifications. The required features could include shelving racks, display cases, free-standing display units, and decorative items such as: track lighting, upgraded ceilings, walls and floors. The retailer is required to pay the full cost of the fixtures and build-outs up front and provide the vendor with documentation to receive reimbursement. The retailer will own the assets.

Result:

If the allowance paid by the vendor to the retailer is for purchase of products or services that are separable from the underlying product the vendor is selling to the retailer and is measurable, then this allowance is revenue to the retailer and a gross receipt for California sales factor purposes. To be sufficiently separate from the retailer's purchase of the vendor's products, it needs to be that vendor would have entered into an exchange transaction with a party other than the retailer to provide the benefit. This test would be met if the vendor would have purchased the necessary items for display from other than the retailer. To be sufficiently measurable, the retailer must be able to reasonably estimate the fair value of the products and services being provided to display the vendor's products. If these can be reasonably estimated, then the display allowance would be measurable. If both separable and measurable, then the display allowance is payment to the retailer for sale of products or services, revenue to the retailer, and a gross receipt for California sales factor purposes.

- If the display allowance pays for specific, incremental, and identifiable costs incurred by a retailer in selling the vendor's products, then the allowance is a contra-expense for the retailer and not a gross receipt for California sales factor purposes. If the retailer is being reimbursed for specific, incremental, and identifiable costs incurred in selling a vendor's products, then the retailer would not be considered to be engaged in a sale of products or services separate from the products being sold for the vendor and as a result there is no gross receipt for California sales factor purposes.

- For portions of the allowance paid to the retailer that exceed the fair value of the benefit to the vendor and for those allowances not shown to be income/revenue or a contra-expense, the allowance reduces COGS and not a gross receipt for California sales factor purposes.

6. **Slotting Fees**: A retailer enters into an agreement with a vendor where the retailer agrees to stock and display the vendor's new product. There are specific requirements for how and where the product must be displayed. The allowance is one up-front payment paid before the vendor sells any products to the retailer.

   Result:

   Slotting fees generally do not meet the separability requirement as the retailer is not providing an identifiable benefit to the vendor that is separate from the underlying product sold to the retailer. That is, the vendor would not purchase display space from a retailer that was not selling the vendor's product. This allowance is unlikely to be payment for specific, incremental, and identifiable costs incurred by the retailer so the allowance would not be a contra-expense. As a result, the fees (allowance) reduce COGS and are not gross receipts for California sales factor purposes.

7. **Short-Term Promotional Price or "Buy Down":** A retailer enters into an agreement with a vendor where the vendor agrees to reimburse the retailer for offering a temporary reduced selling price on certain products for a short-term promotional period. The allowance is based on the number of goods sold by the retailer to its customers rather than the number of products purchased by the retailer. The retailer takes the reduced price from the customer and then waits for the vendor credit or payment. At the end of the promotion the retailer submits the records of sales to the vendor and receives either a credit or a payment.

   Result:

   There is no product or service that the retailer is selling to the vendor that is separate from the underlying product that the vendor is selling to the retailer. This allowance reduces COGS for the retailer and is not a gross receipt for California sales factor purposes.